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Faculty Working Papers

WEAPONS AGAINST UNEMPLOYMENT AND INFLATION

Why Not Minimize the Social Costs?

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Why Not Minimize the Social Costs?

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Unemployment continues to hit hardest those least equipped to bear adversity: unskilled laborers, racial minorities, and the poor. At the same time a slowing but stubborn inflation continues to upset household budgets, especially for those who need medical care and new housing or who depend on public transportation.

In its efforts to achieve economic stabilization, the administration has devoted more energy to the fight against inflation then to the more recent fight against unemployment. It has carried on its attack against inflation by curtailing demand, a policy that tends to benefit a different group of people from those who suffer the income loss of unemployment. Yet an attack against unemployment is tantamount to a direct attack against many of our social problems: urban and rural poverty, crime, growing welfare rolls. It is noteworthy that it costs only a little more to employ idle workers than it does to maintain them and their families. Furthermore, unemployment which these days hovers just below 6%, does not hit all groups equally; it is currently about 11% for construction workers, about 17% for teenagers, about 9.5% for blacks, and about 30% for black teenagers. Reducing unemployment would reduce quickly the number of

areas designated as "depressed" -- currently about fifty. It would also contribute to longer-run growth by encouraging investment in new technology. If, instead of relying entirely on curtailing demand, a more comprehensive wage-price or price-incomes policy were used to help restrain any continuing inflation, we could reduce both unemployment and the cost of living squeeze. (Such a policy, incidentally, might also help reduce labor unrest, which threatens to result in a steel strike in August.)

The management of the economy is of course fundamental to the public interest. It is also fundamental to President Nixon's reelection prospects and to the composition of the next Congress. The Nixon Administration attacked inflation with such vigor that it has since found it necessary to counteract the resulting effect by announcing a "full employment budget" designed to stimulate economic activity. Yet tightening of fiscal and monetary policies in 1969 was clearly necessary, for no administration committed to a balanced stabilization policy can allow inflation to run unchecked at rates in excess of 5-7%. But inflation was curbed at a price, and it is reasonable to ask if the same or better results could not have been achieved at less cost.

In its February Economic Report the Administration announced that it plans to allow enough slack to remain in the economy throughout 1971 to maintain continuous downward pressure on the rate of inflation. Administration economists, who are aware of the lag between the time a policy is started and the time its effects

are felt, plan to have the economy return to full employment "by mid-1972," just in time for elections. Plans for improving conditions in the construction industry were announced, but it is also important to consider other weapons that could be used as part of a price-incomes policy to restrain the more important remaining sources of inflation. The need for a sensible wage-price policy is not a temporary one, for creeping inflation can be expected to remain a problem as long as the economy is kept close to full employment levels. But the social cost of maintaining a pool of 5½-6% unemployed, as was done throughout the 1958-1963 period, is just too high a price to pay as a continuing restraint on a modest inflation.

The Trade Off Between Unemployment and Inflation

The policy choices open to President Nixon and his key economic advisors are most easily understood by reference to a modified Phillips curve. This curve plots the rate of consumer price increases on one axis and the rate of unemployment on the other, showing that increases in unemployment reflecting slack demand tend to be accompanied by reductions in inflation. A similar trade off between unemployment and inflation has been found to exist in northern European countries. If refinements are introduced to allow for the effect on wage rates of lagged price increases, labor productivity or profit rate changes, and labor "reserves" (workers who leave the labor force as unemployment increases), it is a permanently useful tool for interpreting

economic stabilization policies.[1]

Notice the relatively stable prices throughout 1960-1965 appearing low on the curve in Figure 1. This stability was upset by President Johnson who financed the escalation of the Vietnam war with borrowing rather than with taxes, thereby increasing total demand. Since the economy was already near production capacity and full employment in 1965, excess demand was created, and prices rose throughout 1966-68, as shown to the left along the curve.

Momentum carried the economy upward in the first half of 1969. But President Nixon switched the federal budget to a huge $13.4 billion surplus by mid-year and encouraged the most intensive squeeze on credit in the history of the Federal Reserve System. Together these fiscal and monetary policies stopped the upswing, with the upper turning point of industrial production coming early in September 1969.

Then the economy started downward and unemployment rose. But even though it is well known that the main effect of interest rates in discouraging construction appears only after a lag of six to nine months, monetary policy permitted long term interest

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[1]Strictly speaking, product prices are influenced by demand pull (e.g. unfilled orders, operating capacity limits, the "gap" between potential and actual output), and by cost push factors (e.g. wage costs, profit, raw material prices, and labor productivity). The adjustment period is short; 3-6 months as estimated by Eckstein and Fromm. With wage rates influenced by the factors listed in the text as developed by Perry, Simler, Tella, and others, the wage equation may be substituted into the price equation to obtain the "reduced form" explanation of prices in the modified Phillips curve.

rates to rise on into 1970. As would be expected, the unemployment rate in the construction industry climbed, reaching 12.7% by September 1970.

The trough of the recession was reached in November 1970, when real gross national product and the industrial production indices were at their low points. Overall unemployment reached its high of 6.2% in December. This growing unemployment was stopped by an earlier easing of fiscal policy leading to a $14 billion Federal deficit by June 1970. The budget deficit occurred largely because of an increase in unemployment compensation passed by Congress, an automatic increase in unemployment payments as unemployment grew (together a $9 billion increase), expiration of the remaining 5% Vietnam war surtax (a $3.5 billion tax decrease), and some automatic reductions in Federal income tax receipts as income fell. All of these expenditure increases and tax cuts put purchasing power in the hands of consumers. The increased purchasing power reversed the decline in effective demand within three to six months and contributed heavily to the upturn of the economy in December.[2] Budget deficits are much misunderstood, but they are absolutely vital in filling in the troughs of economic activity,

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[2]Evidence consistent with a lag of 3 to 6 months before the effect of changes in fiscal policy are felt is offered by simulation tests of the Brookings econometric model of the United States economy. The tests found that first round effects of fiscal policies of this type were completed within three months and that three-fourths of the total multiplied effects were completed within six months.

for they leave tax dollars in the hands of consumers and reverse declining demand.

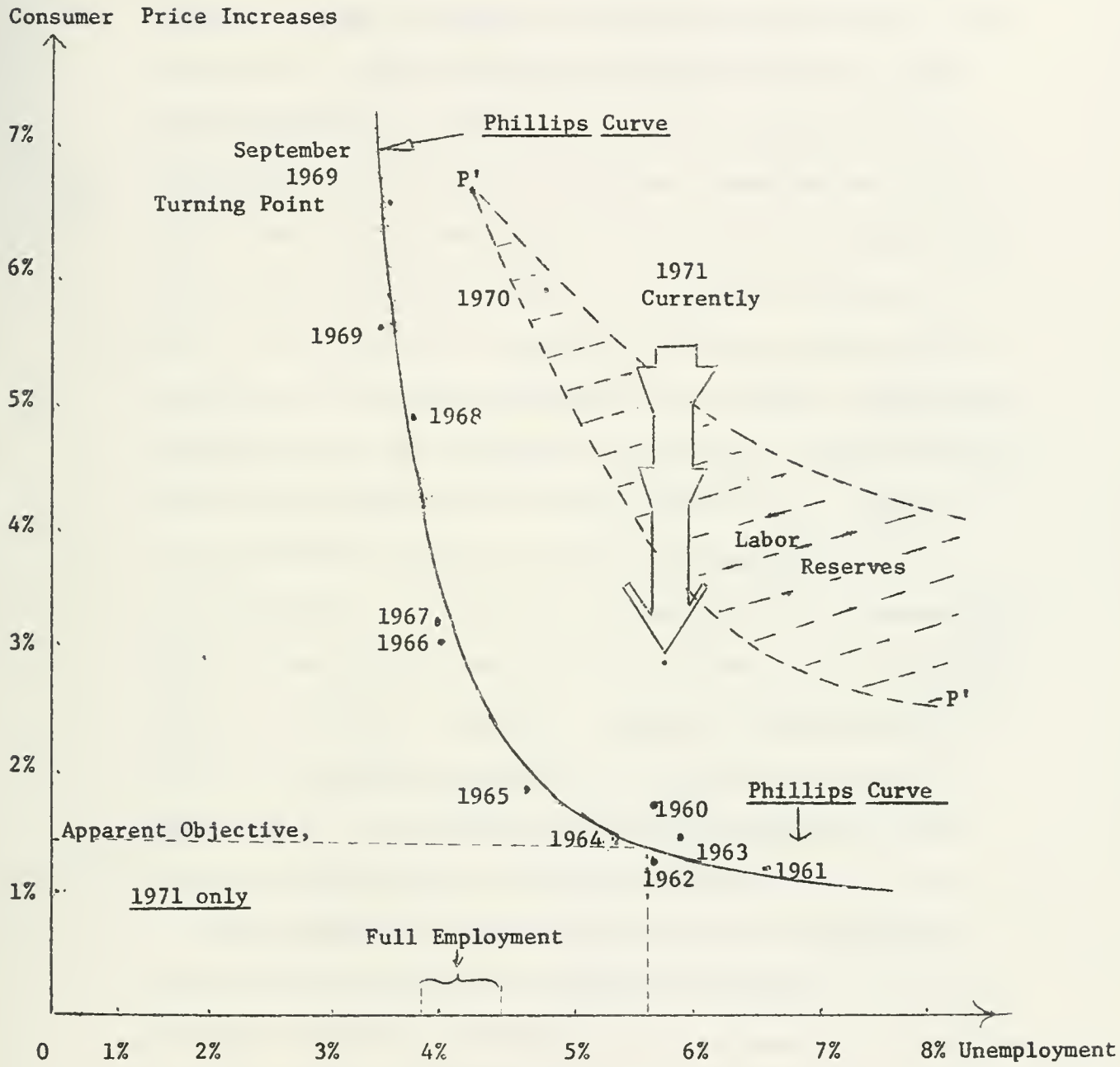

Figure 1 Trade-Off of Inflation vs Unemployment

Monetary policy also changed in the summer of 1970, allowing long term interest rates to decrease a little. It has been estimated that the "decision lag" between the time interest rates are changed by action of the Federal Reserve Board and the time business men decide to invest is very short, generally less than three months. But there is a much longer production lag before plant or residential construction is put in place and workers and material suppliers paid. In fact it is two and a half years before all the effects of a decrease in interest rates are felt, with about half the effect completed in nine months. Nevertheless, this decrease has been reflected in an increase in housing starts, which began in December 1970 consistent with the lag before the first noticeable effects occur that has been estimated to be six to nine months. An increase in other forms of new construction began in January 1971; these are both increases in real investment that can be expected to continue. In fact the enormous pent up demand for new housing could lead to a significant increase in housing starts in early 1972 because long term interest rates continue downward right now from 8½% toward 6% in many cities.

Unfortunately, the steady upward movement of construction costs tends to choke off this demand for new housing. It remains to be seen how effective President Nixon's attempts to do something about the restrictive practices of some of the A.F. of L. craft unions and the troublesome markup practices of lumber yards (price increases of 42% just since December 1970) will be. But

the recovery of the construction industry, not to speak of the welfare of the continuing pool of less skilled and black unemployed construction workers, depends heavily on his success.

In general, then, the administration's effort to prevent first runaway inflation and then massive unemployment has been successful, although we have almost come to take such stabilization for granted. The success of overall stabilization policies, based admittedly on an uneven application of improved economic knowledge, in at least six northern European countries and the United States in the postwar period has been striking.[3] There has in fact been no serious depression or currency breakdown in any of these nations since World War II. President Nixon accepted whole-heartedly the principle of a full employment budget in his January Budget Message. Expenditure is to balance with revenue as projected at full employment; this means an actual budget deficit for the new fiscal year following on the $18½ billion for the current fiscal year ending June 30, 1971. Therefore stabilization policy can be expected to take care of the upper and lower ends of the Phillips curve in Figure 1 -- that is, runaway inflation and massive unemployment -- permitting attention to be turned to solving the problems that remain when unemployment is between 3.9 and 4.5 per cent.

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[3] See Bent Hansen, Fiscal Policy in Seven Countries, Organization for Economic Cooperation and Development, Paris, 1969, pp. 69-73.

A Price-Incomes Policy?

Wage-price guideposts were used in the 1962-1967 period. After that, apart from some ineffective jawboning and some talk about all out controls which nobody wants, this approach was dropped. Now, however, the Council of Economic Advisors reports immediately to the Cabinet Committee on Economic Policy any exceptionally inflationary wage and price developments, so that the Cabinet Committee can consider appropriate Federal action. The next step should be to articulate a coherent price-incomes policy and subject it to public discussion. Perhaps a few suggestions can be made here about a price-incomes policy that would help improve the trade off between unemployment and inflation, thereby minimizing unemployment and contributing to the achievement of a sustainable real growth of 4½% a year.

From the 1962-1967 experience it was learned that wage-price policies work only as a supplement to general fiscal and monetary stabilization policies designed to stabilize demand. When, for example, there is excess demand, as there was in 1967-1968, it is unrealistic to expect workers to limit voluntarily their increases in wages to a fixed rate tied to productivity increases (usually about 3.2% a year) and firms not to raise their prices unless there is all out rationing. And at the other extreme when there is considerable unemployment, if it is after a period of rising consumer prices, increases in wages mean that at

first workers' real incomes are catching up to the cost of living. But if the slack persists, the guidelines are redundant. A price-incomes policy therefore should probably be used only when the economy is in the middle range of the Phillips curve, as it is now, with unemployment ranging from 3.9 to 6.5 per cent.

A price incomes policy can certainly work to alleviate bottlenecks by increasing supply. One example is medical care. There is an acute need for more doctors, especially general practitioners, pediatricians, and internists. Above all, there is an acute need for more doctors in rural areas and urban ghettoes. At the same time medical care prices have risen considerably more rapidly than any other major item in the consumer price index. They stand at 170 on a 1957-1959 base of 100, compared to 133 for food and 160 for construction. Part of this may be due to the fact that doctors, rather than the public, control the policies of the Blue Shield plan and of many hospitals, and part may be due to the lower rates of growth of productivity that Professor Baumol and others have suggested may be typical of many service industries. In any case, from the point of view of the national interest, President Nixon's veto of the doctor training bill is absolutely incomprehensible. For even with government help, it takes a long time to train doctors.

An approach to a price-incomes policy that is appropriate for non-service industries is to satisfy excess demand by selling government stockpiles and easing import restrictions. In the

steel industry, for example, the possibility of easing import quotas was explored by President Nixon. After very large price increases were announced in January 1971, President Nixon, probably as a trial balloon, directed his Cabinet Committee on Economic Policy to reexamine the agreement with Japanese and EEC steel producers that limits their sales of steel in the United States. Since increased steel imports would change the competitive situation, U.S. Steel adopted a somewhat smaller price increase. This is important, because U.S. Steel's prices act as a benchmark for the rest of the industry. Furthermore the size of the January price increase may influence the policy of the United Steelworkers Union. Had the increases been smaller, the union might have moderated its demands when its contract comes up for negotiation this summer.

Finally, a price-incomes policy is concerned with the economy-wide wage-price escalation, not just with conditions in a few industries. The process goes something like this. Prices depend primarily on total demand, on changes in wages and profit rates, and on rates of increase in productivity per man hour. If high demand should move some prices upward, households will not sit idly by and watch their real incomes deteriorate. There will be pressure for higher wages and salaries, and after a lag these wage rates will be subject to cost of living adjustments. Business firms pass these wage increases along to consumers in the form of a second round of price increases, often with a little additional

margin for themselves. This encourages another round of wage increases, which by this time can have become considerably greater than the increase in productivity. Workers see themselves as regaining lost ground or in Professor Friedman's terms, adjusting to inflationary expectations.[4] If there is unemployment and slack demand, new "safety margins" cannot be built in on each round, and the escalation process must thus slow down.

Some kind of reasonable price and wage criteria that define what is excessive in relation to increases in productivity can help to damp this wage-price escalation. Most research indicates that the guideposts, used during the period 1962-1967, did have some effect; Canada is currently having some success with a wage-price policy; and most of the major European countries have used price-incomes policies of different kinds for some time. Of course, there is a change in the distribution of real income in favor of entrepreneurs during the period of excess demand, followed by a reduction in profits as labor negotiates cost of living adjustments and catches up, but this is a dynamic effect that any policy must take into account.

The formation of a National Commission on Productivity is certainly a step in the right direction, for increases in productivity will move the modified Phillips curve to the left. Notice the 1970

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[4]Professor Milton Friedman and others might prefer to interpret the lagged price term, which is prominent in most research on Phillips wage equations, as also measuring the state of inflationary expectations.

observation in Figure 1, a year during which productivity grew at only 1% and this, combined with 1969's price increases, held the Phillips curve to the right. Then notice the 1971 objective, based on an increase in productivity closer to the more normal rate of 3.2%. Increasing productivity means that for any given rate of price increases, there need be less unemployment. The Commission should be assigned the task of developing appropriate norms for non-inflationary price and wage behavior. But since its responsibility is broader than this, the final responsibility for a price-incomes policy should rest with the Council of Economic Advisors.

Opportunities for Increasing Productivity

Important opportunities for maintaining high rates of growth in productivity lie in the recognition that investment in human capital contributes to productivity and long run growth. There are other well-known ways of increasing productivity: for example, avoiding recessions, which underutilize plant capacity and white collar workers, and lead to low investment in new technology; reducing tariffs; reducing by anti-trust action the barriers to entry into industries; and organizing firms and industries more efficiently. But awareness of the opportunities that exist to increase productivity by investing in human resources is new. Economic research is now flourishing on the connection between investment in education, on-the-job training, health, prisoner rehabilitation, and job mobility to productivity in later

life. Such investment increases productivity not just in terms of physical output but also in terms of the quality of human life.

Sweden offers an example of a country that through its various social welfare programs has had a very high rate of public investment in human resources accompanied by a vigorous policy of encouraging job mobility. The Swedish economy has been at full employment throughout most of the postwar years, with prices rising at 4% as compared to 1 3/4% in the United States, and a faster 4.9% rate of real economic growth.[5] This faster growth may be partly the result of Sweden's investment in human resources, which allows people to become more productive and encourages more effective utilization of their skills.

Defense Cuts?

The cost of the war in southeast Asia has been estimated at $30 billion a year. There is evidence that expenditures on non-defense public goods are normally curtailed and domestic needs deferred during wars. But it has also been shown that these needs are typically met when the war ends, and many have hoped that the withdrawal from Vietnam would release funds to meet these needs. Yet the budget for fiscal 1972 provides for a remarkably steady outlay compared to fiscal 1971 for military operation and maintenance ($20 billion), military personnel ($20 billion plus $2.4 billion for pay raises), and procurement ($17.9). The defense budget, which reached a peak of $80 billion

[5]See Fiscal Policy for a Balanced Economy, OECD, December 1968, edited by JCR Dow, pages 80 and 105.

in fiscal 1970, was cut temporarily by $4 billion in fiscal 1971, and is now budgeted to return to $77.5 billion in the new fiscal year. This cut, together with the dropping of the SST, led to some temporary unemployment in the west coast aerospace industry. But the expiration of the surtax on June 30, 1970 left enough purchasing power in consumers' hands to more than compensate for the defense cut. Purchasing power will also be increased by the increase in the standard income tax deduction from $600 to $625 and by the additional 5% tax cut scheduled for 1972 that was part of the tax reform measure passed by Congress in 1969. Thus, the decrease in spending on the war is being offset partly by tax cuts and is being shifted partly to other defense purposes. So the Vietnam withdrawl is not responsible for the overall level of unemployment, but also at the moment it is not directly available to help meet long deferred non-defense needs.

Nor does the Administration plan to finance these non-defense needs -- domestic education, welfare reform, health care, crime prevention, improvement of environmental quality -- by increasing the percentage of GNP spent on social programs. The budget projections through 1975 show public expenditures on non-defense needs remaining at approximately their current 29% of GNP, a smaller percentage than occurs in any of the major northern European countries.

Instead, budget increases for public expenditures are to be financed by an $11.6 billion deficit in fiscal 1972 and by the

projected growth in the economy. But the budget uses a very optimistic projection for growth, showing the GNP at $1,065 billion in 1972, whereas most economists predict it will be about $1,050 billion. (The first quarter GNP is $1,018 billion, and about $1,030 billion would have been needed to reach $1,065 billion for the year.) The higher forecast is based on a model constructed by Art Laffer, an economist in the Office of Management and the Budget. His model rests on the debatable assumptions that the overall impact of changes in budget policy washes out to zero after the first quarter and that the impact from changes in the quantity of money on consumer and investment spending is instantaneous. Such a model is unlikely to be acceptable to Arthur Burns, Chairman of the Federal Reserve Board, or to many other professional economists. But it does fit in with a certain amount of administration wishful thinking. If the forecast is not attained, the deficits planned for fiscal 1971 and 1972 will be larger than expected.

Further defense cuts, therefore, should not be expected to cause unemployment. Instead they may make it possible to satisfy some of the unmet needs for medical care, education, and other social programs.

A Balancing Act

Given the state of economic knowledge there is no reason the economy cannot be close to full employment and to its potential for real growth without inflation. There is no reason the

economic impact of Vietnam cannot be phased out smoothly.

The Administration has quite properly applied tight monetary and fiscal policies to control inflation. But it has failed to use supplementary programs to ease troublesome bottlenecks and it lacks a comprehensive price-incomes policy that would include efforts to increase productivity. It also kept long term interest rates high well past the inflationary peak, maintaining excess slack in the construction industry.

The "mid-course correction" scheduled by the Administration this summer needs to consider the relation between investment in both new physical equipment and human resources and economic growth. Federal expenditure is not inflationary when the economy is as far away from full employment as it currently is, particularly if further demands are not made on a few bottlenecked sectors. The repeated curtailment of HEW expenditure, especially when there are important opportunities to raise productivity through applied research and to develop human resources among the unemployed, appears somewhat short sighted.

It will take a balancing act to return to full employment and to near potential growth immediately without inflation. But the means are available. It would be unfortunate to have to pay the social cost of maintaining a continuing pool of unemployment together with more inflation than is necessary until mid-1972.

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